UNITED STATES DEPARTMENT OF AGRICULTURE
FARM CREDIT ADMINISTRATION
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QUARTERLY SUMMARY OF CASES

RELATING TO

FARMERS' COOPERATIVE ASSOCIATIONS

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Prepared for the

COOPERATIVE RESEARCH AND SERVICE DIVISION

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COOPERATIVE RESEARCH AND SERVICE DIVISION

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COOPERATIVE HELD INELIGIBLE FOR EXEMPTION UNDER SECTION 101 (8) OF TAX CODE

On December 27, 1950, the United States Circuit Court of Appeals for the Second Circuit affirmed the decision of the United States Tax Court (13 T.C. 150) in Consumer-Farmer Milk Cooperative, Inc., Petitioner v. Commissioner of Internal Revenue, Respondent. The decision of the Tax Court was noted in Summary No. 44, December 1949.

The petitioner, a producer-consumers' cooperative, was not tax exempt under the provisions of Section 101 (12) of the Tax Code and sought exemption as a civic league under Section 101 (8). The Court, after holding that the cooperative was not "a civic league, not organized for profit and operated exclusively for the promotion of social welfare", because its rebate distributions were not charitable contributions, and the taxpayer was not exclusively engaged in promoting social welfare, said:

> "In support of its claim to exemption the taxpayer relied heavily on the decision of the Sixth Circuit in United States v. Pickwick Electric Membership Corp., 6 Cir., 158 Fed. (2d) 272 [46-2 USTC Par. 9409]. There a cooperative membership corporation organized to provide low cost electricity in rural communities, in some of which electricity was not previously available, was allowed exemption under section 101(8) despite the fact that its members received benefits in the form of patronage refunds or reduced rates. The Commissioner urges that the case is distinguishable because, as the court noted at page 276, whatever small profit was made 'was only a tentative one and so closely related to a readjustment of rates that it was not an actual profit in the real meaning of the word over the longer period of time,' and because 'there was no cash distribution' (page 277). Unless these differences are sufficient to distinguish it from the case at bar we must respectfully decline to follow it."

It is interesting to note the Court's remarks to the following effect:

> "Finally it should be noted that essentially the taxpayer is a farmers' cooperative, since the patronage dividends paid to consumer members are so insignificant as to be negligible. Section 101(12) grants exemption to farmers' cooperatives on terms therein set forth. Concededly the taxpayer does not meet those terms; and it makes no claim to exemption thereunder. The detailed classification of section 101 suggests that when Congress set up in subdivision (12) the conditions on which a farmers' cooperative might gain exemption, this was intended as the exclusive subdivision for such a cooperative. This question is mentioned merely by way of caveat; it is unnecessary to decide it. Even on the assumption that the taxpayer might qualify for exemption under subdivision (8), we hold for reasons already stated that it failed to satisfy the requirements."

On this question there appears to be a conflict in view between the second and sixth circuits, although in each case the comments were dicta. In United States v. Pickwick Electric Membership Corporation, 6th Circ., 158 F. 2d 272 (cited by the Court in this case and discussed in Summary No. 33, p. 17), the Court said (p. 276):

> "We do not agree with appellant's contention that since the appellee is a cooperative company within the general provisions of § 101 (10) [12] it can not seek exemption under § 101 (8). The two exempt classifications are cumulative, not mutually exclusive."

It might be noted that while, as a matter of law, the various exempt classifications may not be exclusive, considered from a practical viewpoint, it is unlikely that a corporation so organized as to fall within the farmers' marketing and purchasing cooperative classification, if not exempt under Section 101 (12), would be able to make a showing that it had the requirements entitling it to exemption under any other class.

(R. D. Burchard)

Aside from the legal aspects of this case, there is in the petitioner's type of organization an interesting and somewhat novel application of cooperation. The aims and welfare objectives of the public as consumers and the farmers as producers are most often regarded as embracing at least some measure of conflict. Yet here is an association which combines the two elements as joint beneficiaries of its operation, as revealed in the following quotation from the court record:

> "After its first full year of operation the board of directors decided to pay patronage dividends of 15 cents per 100 quarts of milk purchased by consumers and 7-1/2 cents per 100 quarts of milk furnished by farmers. The same dividend rates have been continued in subsequent years."

That this hybrid operation has prospered is evidenced by the following:

> "How successful it has been in making profit [sic] is evidenced by the fact that starting in 1938 with a borrowed capital of $6,000, its balance sheet as of September 30, 1943 shows assets totalling more than $138,000 and a net worth of more than $15,000."

A good portion of this growth, however, apparently is attributable to the fact that many consumers failed to call for their patronage dividends, as is brought out in the following excerpt:

> "This result has been attained in large part by reason of the way it has dealt with consumer dividends. Consumer dividends were declared on the total volume of the taxpayer's sales, but a consumer patron can claim his dividend only if he turns in printed vouchers, detached from milk containers, evidencing purchases of at least $5 in the dividend year. Unclaimed consumer dividends are transferred to the general reserve fund one year after the declaration date. In actual practice only a small percentage of

consumer dividends are ever claimed and paid. The record shows that the total amount of dividends declared payable to consumers for the fiscal years 1939 to 1943 inclusive was $39,922.53 and of this amount only $3,050.25 was paid."

Thus, this experiment in combining the interests of two normally opposing groups has not worked out in practice to produce an equality of benefit for each group. However, this was merely a failure in organization technique and therefore has no real bearing on the question of whether the duality of interest is something of value, or something unworkable.

(G. J. Waas)

WITHOUT PRIOR LEGAL OBLIGATION TO PAY, PATRONAGE DIVIDENDS NOT DEDUCTIBLE OR EXCLUDABLE

On December 13, 1950, the United States Tax Court, by Judge Rice, issued a memorandum opinion in Beaver Valley Canning Company v. Commissioner of Internal Revenue (Docket No. 22086). Excerpts from the statement of facts, and the opinion in its entirety, follow:

* * * * * *

"The sole issue raised is whether 'patronage dividends,' 'patronage refunds,' or 'repayments' distributed by petitioner to its stockholder-customers were includible in its gross income. Some of the facts were stipulated.

FINDINGS OF FACT

"The stipulated facts are so found and are incorporated herein. Petitioner was incorporated March 1, 1937, under Chapter 384 of the 1935 Iowa Code entitled 'Corporations for Pecuniary Profit,' to conduct and carry on a canning business and any business incidental thereto. Its books of account are maintained and its tax returns are filed on an accrual basis. Federal tax returns for the fiscal years ending April 30, 1944, 1945 and 1947, were filed by petitioner with the collector of internal revenue for the district of Iowa, Des Moines, Iowa.

"The stockholders of petitioner are wholesale cooperative grocery companies who are members of the National Retailer Owned Grocers, known as N.R.O.G. The organizers were also members of N.R.O.G.

* * * * * *

"At a Board of Directors meeting on June 7, 1941, a three per cent discount plan based on gross sales was authorized as of July 15, 1941. This was ratified at a stockholder's meeting on June 5, 1942, and a resolution was passed to continue this discount plan

for the 'current year,' i. e., the year ending April 30, 1943. By action of the Board of Directors on August 28, 1943, this was continued for the fiscal year 1943-1944. Another resolution passed at this same meeting allowed sales to non-shareholder-customers, and a distinction was made between customers who owned petitioner's stock and those who did not. Only the former were to be entitled to such 'patronage refunds' as the Board of Directors should decide upon from time to time. After an audit report determining the petitioner's earnings for the fiscal year ending April 30, 1944, the Board of Directors at a meeting on June 10, 1944, declared a 'patronage refund' of 15 per cent, based on gross sales, to each shareholder-customer for the year. The sum of $27,396.78 was paid on June 22, 1944. After a similar meeting on May 5, 1945, a 4-1/2 per cent 'patronage refund,' based on gross sales to shareholder-customers, was declared for the fiscal year ending April 30, 1945, involving a total sum of $12,179.30. Following a preliminary audit for the year ending April 30, 1947, at a meeting of the Board of Directors on April 22, 1947, a resolution was passed to 'repay' 12-1/2 per cent of the gross sales. The total sum paid was $89,796.16. The Commissioner disallowed deductions of these amounts for the years ending April 30, 1944 and 1945, and disallowed exclusion of the amount from the gross sales for the year ending April 30, 1947.

* * * * * *

"There is no provision in the statute under which petitioner incorporated, in its articles of incorporation, or in its bylaws providing for the declaration or payment of patronage dividends, for the years herein involved. Petitioner's officers had informed shareholder-customers that there would be patronage refunds and this was one of the reasons purchases were made. However, the amount of such refunds was indefinite.

OPINION

"RICE, Judge: The sole issue in this case is whether certain 'patronage dividends,' 'patronage refunds,' and 'repayments' made by petitioner to its stockholder-customers were includible in petitioner's gross income and taxable to it; or whether such 'dividends,' 'refunds,' and 'repayments' were the property of the stockholder-customers and not the property of the petitioner.

"Petitioner is an ordinary stock corporation organized for pecuniary profit under Iowa Law. Neither by the Iowa statute under which it was organized, its articles of incorporation, nor its bylaws, was petitioner under a legal obligation to pay patronage dividends to any of its customers. At a meeting on August 28, 1943, the Board of Directors passed a resolution providing that shareholder-customers '* * * shall be entitled to such patronage dividends as the Board of Directors of Beaver Valley Canning Company decided upon, from time to time.' After corporate earnings were known for the fiscal years ending April 30, 1944, 1945 and 1947, at

meetings of the Board, patronage dividends to the shareholder-customers were declared from the earnings of such year. Petitioner claimed deductions for such amounts in its tax returns for the years ending April 30, 1944 and 1945, and excluded from its gross sales for the year ending April 30, 1947 the amount so paid. The Commissioner determined that such deductions and exclusions were not allowable for Federal taxation purposes.

"There is no express authorization in the Internal Revenue Code for deductions or exclusions of patronage dividends from gross income. Under long established practice, however, true patronage dividends have been excluded on the theory that the dividends are rebates of money belonging to the patrons rather than income to the association. Midland Cooperative Wholesale, 44 B.T.A. 824; United Cooperatives, Inc., 4 T.C. 93; Harbor Plywood Corporation, 14 T.C. 158. This has been recognized by the Treasury Department in rulings and by decisions of various courts. While petitioner organized under the general incorporation laws rather than under the statutes for cooperative associations, and offered no explanation therefor, such action is not controlling if petitioner actually organized and operates as a true cooperative. American Box Shook Export Association, 4 T. C. 758, aff'd. 156 Fed. (2d) 629. An essential condition for such an exclusion is a pre-existing legal obligation to allocate a patronage dividend in the amount that was allocated or distributed. Farmers Cooperative Company v. Birmingham, 86 Fed. Supp. 201. Such a legal obligation may arise from the statute authorizing incorporation, the corporate charter or by-laws, or some other contract, but it cannot rest upon some corporate action taken after receipt of the money, such as action of the corporate directors or officers. United Cooperatives, Inc., supra; American Box Shook Export Association, supra; Fountain City Cooperative Creamery Association, 9 T.C. 1077, aff'd. 172 Fed. (2d) 666; Farmers Union Co-op Co. of Guide Rock, Neb. v. Commissioner, 90 Fed. (2d) 488.

"While admitting that neither the statute, its charter, nor bylaws obligate it to pay the patronage dividends, petitioner argues that due to the representations which it made its shareholder-customers that there would be patronage dividends, and their reliance on such representations when purchasing, that it was bound to pay such refunds on the ground of promissory estoppel, and, therefore, that a binding legal obligation existed for such payments. Petitioner also argues had it not declared the patronage dividends it would have been subject to suit, but cites no cases where in a situation such as this, such a suit was allowed or successful. Nor have we found any case exactly in point. In Rhodes v. Little Falls Dairy Company, 245 N.Y. Supp. 432, aff'd. 256 N.Y. 559, 177 N.E. 140, plaintiff was allowed an accounting where he sold milk to the defendant corporation under a contract which provided he would receive a proportionate share of profits after amounts were set aside for dividends, reserves, supplemental expenses, etc. His sole contention was that profits were incorrectly computed, resulting in his receiving too little.

"In American Box Shook Export Association, supra, the taxpayer was a sales organization buying products from its shareholder-vendors. At the close of each year the taxpayer's directors would determine the amount of profits which could be distributed and the distribution was made on the basis of the amount purchased from each member. While neither the articles of incorporation nor the bylaws required the profit to be distributed, there was evidence of an 'understanding' that it would be done. An amendment to the bylaws had been suggested but never passed. We held that this 'understanding' was not a contract, and since the petitioner was under no obligation to make any distribution until the Board of Directors had acted, the amounts paid were taxable income to the taxpayer. For the year there in question, about $7,000 was distributed, while over $13,000 was reported as taxable income. The evidence did not show that this latter amount was set up as a reserve or held back for any like reason. We felt it could be used for dividends or anything else, and that for such reason there was no legal obligation compelling distribution of a definite amount or percentage. On appeal, our decision was affirmed. In Farmers Union Cooperative Company v. Commissioner, supra, the taxpayer was held taxable on the patronage dividends where the statute under which it organized provided that part or all the profits could be distributed. Since the receipts could be used for a number of things and only a portion was required to be distributed, it was held that the directors had a discretion which negated any existing obligation.

"Similarly, in the case at bar, there was no showing of any definite and certain amount or percentage which would enable a court to find a valid contract even though there was a 'representation.' To have a valid contract, there must be certainty. A promise may attempt to define a price but may do so too indefinitely for enforcement. Williston on Contract, §41. As in American Box Shook Export Association, supra, petitioner here reported taxable income for the years in controversy and no evidence as to what this was kept for was offered. It could have been used in a number of ways. Therefore, we hold, that since the Board of Directors was under no legal obligation to declare and make such a distribution to its shareholder-customers, respondent's determination is sustained.

Decision will be entered for the respondent.

ENTERED DEC 13 1950"

(R. D. Burchard)

SELLER HELD ENTITLED UNDER ROBINSON-PATMAN ACT TO INTRODUCE EVIDENCE TO EXPLAIN REASON FOR PRICE DIFFERENTIALS

In a proceeding before the Federal Trade Commission, it is proper under the Robinson-Patman Act for a corporation to submit evidence to show, with respect to a charge of price discrimination, that the seller has

made a price differential in good faith to meet a lawful and equally low price of a competitor.

The Supreme Court on January 8, 1951, rendered a decision in the case of Standard Oil Company v. Federal Trade Commission, 340 U.S. 231, in which the Federal Trade Commission challenged the right of the Standard Oil Company, under the Robinson-Patman Act to sell gasoline to four comparatively large "jobber" customers in Detroit at a less price per gallon than it sold like gasoline to many comparatively small service station customers in the same area. The company's defenses were that (1) the sales involved were not in interstate commerce, and (2) its lower price to the jobbers was justified because made to retain them as customers and in good faith to meet an equally low price of a competitor.

The Court held that the sales were made in interstate commerce.

With respect to the petitioner's contention that the sales were made in good faith to meet an equally low price of competitors and to retain customers, the opinion shows that the petitioner offered evidence, but that the Commission treated such evidence as not relevant.

The Court concluded by reversing the judgment of the Circuit Court of Appeals and remanding the case to that Court with instructions to remand it to the Federal Trade Commission to make findings in conformity with the Supreme Court's opinion.

(R. D. Burchard)

DECISION HOLDING SECRETARY OF AGRICULTURE EXCEEDED HIS STATUTORY POWERS IN MAKING ORDER REGULATING MARKETING OF MILK SOUGHT TO BE REVIEWED BY SUPREME COURT

In the case of Brannan v. Stark, a petition for certiorari was filed with the Supreme Court on February 6, 1951.

The United States District Court for the District of Columbia (Stark v. Brannan, 82 Fed. Supp. 614) held that the plaintiffs were entitled to an injunction restraining the enforcement of a section of an order of the Secretary of Agriculture regulating the handling of milk in the Greater Boston area. The Circuit Court of Appeals affirmed the decision of the District Court (unreported to date). The petition seeks a review of these decisions by the Supreme Court. The Supreme Court in Stark v. Wickard, 321 U.S. 288, held that the provisions of the order of the Secretary were reviewable by the Courts.

This litigation involves the power of the Secretary of Agriculture, under the Agricultural Marketing Agreement Act of 1937, to provide for payments to cooperatives for the performance of market-wide services, as a requirement incidental to and not inconsistent with other provisions of

the Act, and necessary to effectuate the other provisions of the order, and to require the amounts paid for such services to be taken into consideration prior to determining the basic blended price.

(R. D. Burchard)

CONTRIBUTIONS MADE TO NATIONAL TAX EQUALITY ASSOCIATION NOT DEDUCTIBLE FROM GROSS INCOME

The Tax Court of the United States has held in Roberts Dairy Company, Petitioner v. Commissioner of Internal Revenue, Respondent (Docket No. 20442) that contributions to the National Tax Equality Association are not deductible in computing net income. In 1943 the petitioner made a contribution to the Association. The sole issue for determination was whether this contribution was deductible from gross income either under Section 23(a)(1)(A) of the Revenue Code as an ordinary and necessary expense or in the alternative as a contribution to a corporation created or organized and operated for educational or other specified purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda or otherwise attempting to influence legislation.

The findings of fact show that the National Tax Equality Association was organized and primarily operated from its inception for the carrying on of propaganda, the ultimate objective being a revision in the tax structure.

The Court said in part:

> "The efforts of NTEA are directed against the tax advantages enjoyed by cooperatives and similar business organizations. Since these advantages were acquired through tax statutes specifically granting them, a change must come by way of a revision of the statute and this can be accomplished only by legislation. Hence, the only reasonable purpose for the existence of NTEA is to influence legislation and contributions to it were used for that purpose. In the face of section 101 granting the exemptions, petitioner's contention that revision can be accomplished by means other than legislation does not seem plausible. This being the case we can only conclude that the objectives of its activities were the carrying on of propaganda or otherwise attempting to influence legislation under section 23 (q)(2) and the promotion or defeat of legislation or the exploitation of propaganda within the prohibition of section 29.23(q)-1 of Regulations 111. Therefore, the expenditure here in question is nondeductible under either section 23(q)(2) or 23(a)(1)(A).

* * * * * *

"Since the regulations have determined that expenditures made for the exploitation of propaganda or the promotion or defeat of legislation are not deductible as business expenses, we find it unnecessary to determine whether or not these expenditures were ordinary or necessary expenses."

(R. D. Burchard)